



1998

Commercial Transactions

John Krahmer

Follow this and additional works at: <https://scholar.smu.edu/smulr>

Recommended Citation

John Krahmer, *Commercial Transactions*, 51 SMU L. Rev. 783 (1998)
<https://scholar.smu.edu/smulr/vol51/iss4/7>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

COMMERCIAL TRANSACTIONS

John Krahmer*

Although 1997 was a legislative year only a few changes were made in the text of the Texas Uniform Commercial Code.¹ In the litigation arena, cases involving the sale of goods accounted for almost one-half of the decisions reported during the Survey period.² The legislative changes and reported cases discussed in this Article follow the same sequence as that of the Chapters in the Business and Commerce Code.

I. GENERAL PROVISIONS

A. GOOD FAITH

Section 1.203 of the Code provides that every contract governed by the Code includes an obligation of good faith in its performance or enforcement.³ In *Northern Natural Gas Co. v. Conoco, Inc.*,⁴ the defendant entered into a twenty year contract to sell natural gas from wells identified in the contract. The critical language in the contract provided that the defendant was to deliver gas "in keeping with all the quantity and other provisions of [the defendant's] various gas purchase contracts in effect

* Professor of Law and Foundation Professor of Commercial Law, Texas Tech University. B.A., J.D., University of Iowa; LL.M. Harvard University.

1. The Uniform Commercial Code is contained in the first eleven chapters of the Texas Business and Commerce Code. Those eleven chapters comprise the first three volumes of the four volume Business and Commerce Code. The Uniform Commercial Code was originally adopted in Texas during the 1965 legislative session with an effective date of July 1, 1966. See UNIFORM COMMERCIAL CODE, 59th Leg., R.S., ch. 721, §§ 1-101 to 10-105, 1965 Tex. Gen. Laws 1-316. In 1967 it was reenacted as part of the new Texas Business and Commerce Code, the first of the Texas Codes to be promulgated under the Texas Codification Act. See Act of May 25, 1967, 60th Leg., R.S., ch. 785, §§ 1-6, 1967 Tex. Gen. Laws 2343-2782. In this Article all references are to the Uniform Commercial Code as enacted in chapters 1 through 11 of the Texas Business and Commerce Code. TEX. BUS. & COM. CODE ANN. §§ 1.101-11.108 (Tex. UCC) (Vernon 1994 & Supp 1998) [hereinafter the Code].

2. A Survey period generally covers cases and legislation reported from October of one year through September of the following year. Because of differences in timing for the release of opinions for publication, motions for rehearing, and the like, a case may be included that was reported shortly before or shortly after those dates, but most of the cases and legislation discussed are within that time frame. Because of the slightly "fuzzy" nature of this time frame, and because of differences of opinion about the category into which a particular case might fall, there can be legitimate disputes about the classification of cases. However, it appears that, of some forty-odd cases reported during the Survey period, eighteen involved sale of goods issues as an important part of the decision.

3. See TEX. BUS. & COM. CODE ANN. § 1.203 (Tex. UCC) (Vernon 1994).

4. 939 S.W.2d 676 (Tex. App.—El Paso 1996), *aff'd in part, rev'd in part* (Tex. Apr. 14, 1998) (opinion not yet available as of date of publication).

from time to time.”⁵ When the natural gas industry was deregulated, the purchase and resale of gas became unprofitable and the defendant eventually cancelled and bought out all of its contracts with producers.⁶ The net effect of these cancellations was that the defendant no longer had any gas to sell to the plaintiff. The plaintiff sued, alleging that the contract required the defendant to continue purchasing and delivering all gas produced from the wells identified in the contract.⁷ The trial court agreed and instructed the jury that it should find that a breach occurred if the defendant failed to purchase and deliver all gas from the identified wells.⁸

The appellate court disagreed with this interpretation of the contract, ruling instead that the critical contract clause only required the defendant to deliver any gas the defendant actually purchased under its existing contracts with producers; the defendant was not required, however, to keep all of its producer contracts in force for the twenty year term of its contract with the plaintiff but was entitled to cancel the producer contracts as circumstances might require.⁹ While this interpretation permitted the defendant to cancel its producer contracts, the court further held that this was not an unfettered right to cancel, but one that was subject to the obligation of good faith imposed by the Code.¹⁰ Any decreases in delivery were limited to decreases caused by a good faith cancellation of the defendant's producer contracts. The case was remanded for a new trial to determine if the cancellation of all of the producer contracts was done in good faith.¹¹

B. ACCORD AND SATISFACTION

The common law traditionally recognized an effective accord and satisfaction between a debtor and a creditor if the debtor clearly informed the creditor that a payment was being tendered as full payment of an unliquidated or disputed debt.¹² Under the 1962 Official Text of the Uniform Commercial Code that was adopted in Texas in 1965, section 1.207 could be read to allow a creditor who received a check marked “Payment in Full” to avoid an accord and satisfaction by noting “Under Protest,” “All

5. *Id.* at 678.

6. *See id.* at 678.

7. *See id.*

8. *See id.*

9. *See id.* at 680.

10. *See id.* at 681.

11. *See id.* In reaching this conclusion, the court cited *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565 (Tex. 1996), a 5-4 decision, for the proposition that good faith limited the defendant's ability to cancel its producer contracts. As noted in last year's Survey, *Lenape* was a close decision. *See* John Krahmer, *Commercial Transactions*, 50 SMU L. REV. 1025, 1030-31 (1997). The grant of a writ in *Northern Natural Gas* may indicate that the Court has more to say on the issue of good faith in gas production contracts.

12. *See generally* Joseph Gold, *Accord and Satisfaction by Estoppel*, 27 IOWA L. REV. 31 (1941-42) (discussing and citing common law rules on accord and satisfaction).

Rights Reserved” or the like on the check before cashing it.¹³ While this reading was accepted by the courts in some jurisdictions, it was rejected by others on the ground that section 1.207 did not expressly change the common law rule.¹⁴ This split among jurisdictions was reflected by a split among the Texas courts.¹⁵ In response to this uncertainty, the Official Text of section 1.207 was revised to state that the section does not apply to an accord and satisfaction and a new section 3.311 was added to the Chapter on Negotiable Instruments to explicitly govern the use of an instrument for an accord and satisfaction.¹⁶

In *Smith-Hamm, Inc. v. Equipment Connection*,¹⁷ an equipment lessee attempted to settle the lessor’s claim for rent and for damages resulting from the theft of some of the equipment by tendering a check marked “Payment in Full on Account.” The lessor marked out this language and deposited the check in its account. Six months later the lessor demanded payment from the lessee for unpaid rental charges and for physical damage to other equipment that had not been stolen. When payment was not forthcoming, the lessor sued and the jury returned a verdict in favor of the lessor.¹⁸ The lessee appealed, contending that the trial court erred in not instructing the jury on issues of accord and satisfaction and waiver.¹⁹ Citing the line of Texas cases holding that the pre-Code law of accord and satisfaction survived enactment of the Code, the court of appeals ruled there was some evidence of accord and satisfaction and waiver and that instructions on these issues should have been given to the jury.²⁰ The case was remanded for a new trial.²¹

Because the facts of the case arose before the revision of sections 1.207 and 3.311, the court did not concern itself with the effect of the revisions

13. The first version of § 1.207 was identical to the 1962 Official Text of the Code. See UNIFORM COMMERCIAL CODE, 59th Leg., R.S., ch. 721, § 1.207, 1965 Tex. Gen. Laws 1-316, amended by Act of May 28, 1995, 74th Leg., R.S., ch. 921, § 3, 1995 Tex. Gen. Law 4626.

14. Compare *Horn Waterproofing Corp. v. Bushwick Iron & Steel Co.*, 66 N.Y.2d 321, 488 N.E.2d 56 (1985) (creditor could sue for disputed amount after endorsing a “full payment” check with the words “under protest”) with *Cass Constr. Co. v. Brennan*, 222 Neb. 69, 382 N.W.2d 313 (1986) (cashing a “full payment” check under protest did not preserve right of creditor to later sue for disputed amount).

15. Compare *Hixson v. Cox*, 633 S.W.2d 330 (Tex. App.—Dallas 1982, writ ref’d n.r.e.) (pre-Code law continues to apply in cases of payment by check for services rendered; question left open whether rule for payment by check for goods changed by Code) with *Robinson v. Garcia*, 804 S.W.2d 238 (Tex. App.—Corpus Christi), writ denied *per curiam*, 817 S.W.2d 59 (Tex. 1991) (no accord and satisfaction occurred when check cashed in full payment of disputed claim after payees endorsed check with language indicating that rights were being reserved on disputed claim). In its *per curiam* denial of a writ of error, the Texas Supreme Court noted that it neither approved nor disapproved of the resolution of the accord and satisfaction issue. See *Garcia*, 817 S.W.2d at 59.

16. The revisions of § 1.207 and Chapter 3 on Negotiable Instruments were approved during the 1995 legislative session and are now codified as TEX. BUS. & COM. CODE ANN. §§ 1.207, 3.311 (Tex. UCC) (Vernon Supp. 1998).

17. 946 S.W.2d 458 (Tex. App.—Houston [14th Dist.] 1997, n.w.h.).

18. See *id.* at 460.

19. See *id.* at 462.

20. See *id.* at 463.

21. See *id.* at 464.

but the facts point out one of the significant aspects of the revised Code. As revised, the result in *Smith-Hamm* would be reversed. The new section 3.311 would require the lessor to repay the amount of the check to the lessee within ninety days after it was paid or an action for any disputed amount would be barred.²² Since the lessor did not demand payment until six months after the check was paid (and, of course, never tendered repayment) the claim would be barred under the revised Code. Furthermore, section 3.311 now also provides that a claim is discharged if the claimant knows that an instrument is being tendered in full satisfaction of a claim.²³ Striking out the language "Payment in Full on Account" is very strong, if not conclusive evidence, that the lessor knew the check tendered by the lessee was being tendered in full satisfaction of the lessor's claim.

II. SALES OF GOODS

A. DIGITAL SIGNATURES

One of the few amendments to the Code passed during the 1997 legislative session was the addition of section 2.108 providing for the use of digital signatures as an effective validating device in contracts for the sale of goods.²⁴ Under this new provision, the statute of frauds contained in section 2.201 of the Code will be satisfied by a digital signature sent as part of "a written electronic communication." While this provision has the merit of recognizing new forms of communication, it also raises some interpretive questions. One could argue that transmission of electronic data over phone lines or fiber optic cable is never "written" as the term is used in the normal sense and that even the conversion of an electronic communication by means of a fax machine or a computer printer does not make the signature one "sent" by means of a "written" electronic communication. The situation becomes even more uncertain if the transmission is by e-mail and viewed only on a monitor. Are the bytes in the computer memory or stored on a computer disk a "written" communication?

A more pervasive issue lies beyond these questions. Why was the new section 2.108 limited to transactions under Chapter 2? Chapter 2A governing leases of goods contains an almost identical statute of frauds provision as that found in Chapter 2.²⁵ One would think that digital signatures would be as useful in lease transactions as in sales transactions, but the section appears to be self-limiting. It is possible that parties attempting to form a contract not covered by Chapter 2 might be able to bootstrap their

22. See TEX. BUS. & COM. CODE ANN. § 3.311(b)(2) (Tex. UCC) (Vernon Supp. 1998).

23. See *id.* § 3.311(d).

24. See *id.* § 2.108. This section provides, in pertinent part that, "A written electronic communication sent from within or received in this state in connection with a transaction governed by this chapter is considered signed if a digital signature is transmitted with the communication."

25. See TEX. BUS. & COM. CODE ANN. § 2A.201 (Tex. UCC) (Vernon 1994).

agreement into meeting the statute of frauds requirements contained in other chapters of the Code by including an appropriate clause in their electronic communication, but the efficacy of such an approach remains to be seen.²⁶ With the growth of electronic commerce on the internet, litigation on this issue is probably not far in the future.

B. WARRANTIES

Virtually all of the litigation reported under Chapter 2 during the Survey period involved one or more of the warranty provisions of the Code.²⁷ In *Bonneau Co. v. AG Industries, Inc.*,²⁸ a buyer provided the seller with a design for a retail display rack to be manufactured by the seller and used by the buyer in stores for the promotion of the buyer's line of optical products. After the buyer was sued for patent infringement by another company that claimed a prior right in the rack design, the buyer sued the seller for breach of the implied warranty against infringement. The court held, however, that the seller was not liable for breach of warranty because the buyer had furnished specifications for the design to the seller and, under the Code, this had the effect of an agreement to hold the seller harmless against any claim arising out of compliance with the buyer's specifications.²⁹ The court further held that the parties had not "otherwise agreed" that the seller would be liable for breach of warranty under the provisions of the Code permitting the parties to vary the warranty against infringement.³⁰

There seems to be something of a pile-up of automobile warranty litigation on the road to the Texas Supreme Court. An important issue in *Miles v. Ford Motor Co.*,³¹ was whether a warranty of fitness for a particular purpose was breached when the passengers in an automobile were injured in an accident because of an allegedly defective seat belt design. The court held that carrying passengers is an ordinary use of a vehicle and would not constitute a particular purpose for warranty purposes. In *Sipes v. General Motors Corp.*,³² the court reached a similar conclusion in regard to an airbag safety system. Unlike the situation in *Miles*, however,

26. Some suggested clauses for such bootstrapping appear in 1 JOHN KRAHMER, VERNON'S TEXAS CODE FORMS ANNOTATED § 2.201—FORM 10 (3d ed. 1997 & Supp. 1997).

27. The warranty provisions of the Code include: TEX. BUS. & COM. CODE ANN. § 2.312 (Tex. UCC) (Vernon 1994) (implied warranty of title and against infringement); TEX. BUS. & COM. CODE ANN. § 2.313 (Tex. UCC) (Vernon 1994) (creation of express warranties); TEX. BUS. & COM. CODE ANN. § 2.314 (Tex. UCC) (Vernon 1994) (implied warranty of merchantability) (Tex. UCC) (Vernon 1994); TEX. BUS. & COM. CODE ANN. § 2.315 (Tex. UCC) (Vernon 1994) (implied warranty of fitness for a particular purpose).

28. 116 F.3d 155 (5th Cir. 1997).

29. See *id.* at 158.

30. See *id.* (citing TEX. BUS. & COM. CODE ANN. § 2.312(c) (Tex. UCC) (Vernon 1994) (permitting the parties to a contract of sale to exclude or modify the warranty against infringement)).

31. 922 S.W.2d 572 (Tex. App.—Texarkana 1996), *aff'd in part, rev'd in part*, 41 Tex. Sup. Ct. J. 562, 1998 WL 124567 (1998) (reversed on other grounds).

32. 946 S.W.2d 143 (Tex. App.—Texarkana 1997, n.w.h.).

the plaintiffs in *Sipes* successfully raised fact issues on allegations of breach of an express warranty and breach of the warranty of merchantability. In *Rodriguez v. Hyundai Motor Co.*,³³ the plaintiff alleged defects in the roof design and restraint system that resulted in injuries to her when the vehicle in which she was riding as a passenger rolled over during an accident. The court denied a claim based on breach of a warranty of fitness for a particular purpose but approved a claim based on breach of a warranty of merchantability. Taken together, these three cases provide the Supreme Court an opportunity to define the requirements needed to establish a warranty of fitness for a particular purpose³⁴ as well as an opportunity to further elucidate the proof needed to show breach of a warranty of merchantability. In a non-automotive context, the court in *ASAI v. Vanco Insulation Abatement, Inc.*,³⁵ reached a similar conclusion with respect to the warranty of fitness for a particular purpose where the buyer of a used industrial vacuum cleaner intended to use it to pick up pieces of asbestos removed from buildings in the course of the buyer's asbestos removal business.³⁶ The court held that use of the machine to pick up asbestos was no different from use of the machine to pick up other types of heavy debris and that the seller itself had so used the machine in its own business. Since the alleged particular purpose did not differ from the ordinary purpose for which the machine was used, the buyer should have sued for breach of the warranty of merchantability instead.

In many instances, the facts giving rise to a warranty claim may also be the basis for a cause of action for Deceptive Trade Practices Act (DTPA) liability, negligence, or strict liability in tort.³⁷ In *Purina Mills, Inc. v. Odell*,³⁸ a herd of dairy cattle was injured by the ingestion of metal particles. Testimony by the plaintiff's expert witnesses identified cattle feed sold by Purina Mills as the source of the particles. Testimony by the defendant's experts showed that the feed might have become contaminated after manufacture and sale or that the metal particles might have come from other food sources at the plaintiff's farm. A jury found in favor of

33. 944 S.W.2d 757 (Tex. App.—Corpus Christi 1997, writ granted).

34. Although the requirements for a warranty of fitness for a particular purpose seem to be rather clearly stated in the Code, the case of *Lester v. Logan*, 893 S.W.2d 570 (Tex. App.—Corpus Christi 1994), writ denied *per curiam*, 907 S.W.2d 452 (Tex. 1995), has cast some doubt on how "particular" the purpose of the buyer must be. In *Lester* the court of appeals held that feeding hay to cattle was a particular purpose, but this conclusion was not satisfactorily explained. See 893 S.W.2d at 574-75.

35. 932 S.W.2d 118 (Tex. App.—El Paso 1996, no writ).

36. See *id.* at 122.

37. See, e.g., *Plas-Tex, Inc. v. U.S. Steel Corp.*, 772 S.W.2d 442 (Tex. 1989) (discussing implied warranty of merchantability and DTPA); *North Star Dodge Sales, Inc. v. Luna*, 667 S.W.2d 115 (Tex. 1984) (breach of express warranty, unconscionability, and DTPA violations); *Crosbyton Seed Co. v. Mechura Farms*, 875 S.W.2d 353 (Tex. App.—Corpus Christi 1994, no writ) (breach of express and implied warranties, breach of contract, strict liability, negligence, and DTPA misrepresentations). Breach of an express or implied warranty is made a DTPA cause of action by TEX. BUS. & COM. CODE ANN. § 17.50(a)(2) (Vernon Supp. 1998).

38. 948 S.W.2d 927 (Tex. App.—Texarkana 1997, writ denied).

the plaintiff on theories of breach of warranty, products liability, DTPA violations, and negligence. On appeal, the court held that the evidence was insufficient to support the verdict on the ground that the plaintiff did not establish that the plaintiff's experts used an appropriate and reliable scientific method to detect the source of the contamination.³⁹ The case was remanded for a new trial.⁴⁰

The line between Code warranties and common-law warranties is sometimes uncertain. In *Ayala v. Bartolome*,⁴¹ a restaurant patron ate two dozen raw oysters at a seafood restaurant and died a few days later from septicemia caused by a bacteria sometimes found in raw oysters. The decedent's family sued on theories of negligence, strict liability, and breach of an implied warranty that the oysters were fit for human consumption.⁴² The trial court granted summary judgment in favor of the restaurant on all theories but, on appeal, the judgment was reversed on the ground that there was evidence sufficient to raise a fact issue on all of the plaintiff's theories.⁴³ Oddly enough, in regard to the warranty of fitness for human consumption, the court cited pre-Code Texas caselaw holding that such a warranty exists as a matter of public policy.⁴⁴ The court neither cited nor explained its failure to cite the warranty of merchantability provision of the Code which directly states, "Under this section the serving for value of food or drink to be consumed either on the premises or elsewhere is a sale."⁴⁵ There was a similar failure to cite this same provision in *Cain v. Pruett*,⁴⁶ where two restaurant patrons suffered injuries after consuming soft drinks that contained fragments of broken glass. Although the court alluded to a breach of warranty as the underlying basis of the patrons' DTPA claims, it did not indicate whether the warranty arose under the Code or as a pre-Code common law warranty.

Among the warranties of merchantability implied by the Code in the sale of goods is a warranty that the goods are adequately contained or packaged.⁴⁷ In *Oser v. Wal-Mart Stores, Inc.*,⁴⁸ a store employee placed a one-gallon glass jar of apple juice in a plastic bag at the check-out counter. On the way out of the store, the bag broke and the plaintiff was injured when she slipped in the juice and fell on the glass. In an action based on theories of negligence and strict liability, the court held there was sufficient evidence to raise a fact question on both theories and sum-

39. *See id.* at 933-35.

40. *See id.* at 941.

41. 940 S.W.2d 727 (Tex. App.—Eastland 1997, no writ).

42. *See id.* at 729.

43. *See id.*

44. *See id.* at 732-33.

45. TEX. BUS. & COM. CODE ANN. § 2.314(a) (Vernon 1994). The court cited *Griggs Canning Co. v. Josey*, 164 S.W.2d 835, 840 (Tex. 1942), and *Jacob E. Decker & Sons v. Capps*, 164 S.W.2d 838 (Tex. 1942), in support of this warranty.

46. 938 S.W.2d 152 (Tex. App.—Dallas 1996, no writ).

47. *See* TEX. BUS. & COM. CODE ANN. § 2.314(b)(5) (Tex. UCC) (Vernon 1994).

48. 951 F.Supp. 115 (S.D. Tex. 1996).

mary judgment in favor of the store was denied.⁴⁹ There is no mention in the opinion of the Code warranty requiring that goods be adequately contained or packaged or that the bag itself be fit for ordinary purposes.⁵⁰

Express warranties and common law implied warranties also overlap the DTPA. In *K.C. Roofing Co. v. Abundis*,⁵¹ in a written contract for roof repair, a contractor agreed that "the entire roof will be warranted against leaks for two years."⁵² Three years and numerous roof leaks later (some of them in areas that did not leak before the work was done), the homeowners sued the contractor under the DTPA. The court held that the contractor had violated the DTPA by representing that the repair work would prevent leaks for two years when, in fact, the leaks were worse after the work was done than before it began. By continuing to bill the homeowners for the work even though the contractor confirmed that the job had been done improperly, the contractor acted "knowingly" to support an award of treble damages under the DTPA.⁵³

Under section 2.316 of the Code, the implied warranties of merchantability and fitness for a particular purpose are not applicable to the furnishing of human blood, blood plasma or other human tissue.⁵⁴ Further, such items are not considered commodities subject to sale or barter, but are treated as medical services instead.⁵⁵ In *Drury v. Baptist Memorial Hospital System*,⁵⁶ a hospital administered a unit of blood from a blood bank instead of using a unit previously donated for that purpose for use by the patient herself. The plaintiff sued for negligence and breach of implied warranty, alleging that she had suffered mental anguish damages arising from her fear of contracting HIV. The court held that summary judgment was properly granted against the plaintiff on the negligence claim because her fear was unreasonable when it was conclusively shown that the banked blood could not have caused any exposure to the virus. As to the warranty claim, the plaintiff attempted to avoid the limitation on implied warranty under the Code by alleging breach of the warranty of good workmanship created by *Melody Home Manufacturing Co. v. Barnes*,⁵⁷ as the basis for a DTPA claim. The court rejected this claim on two grounds. First, the *Melody Home* warranty had never been imposed in the context of professional services involving the exercise of professional judgment.⁵⁸ Second, even if the warranty was recognized, the plaintiff failed to tender any evidence showing that the hospital failed to

49. See *id.* at 118-21.

50. To the extent that the store selected the bag as one fit for the purpose of carrying a one-gallon glass jar of juice, this might even be a case that would meet the more stringent requirements of the warranty of fitness for a particular purpose.

51. 940 S.W.2d 375 (Tex. App.—San Antonio 1997, writ denied).

52. *Id.* at 376.

53. See *id.* at 377.

54. See TEX. BUS. & COM. CODE ANN. § 3.316(e) (Tex. UCC) (Vernon 1994).

55. See *id.*

56. 933 S.W.2d 668 (Tex. App.—San Antonio 1996, writ denied).

57. 741 S.W.2d 349, 352 (Tex. 1987) (implied warranty that services have been performed in a good and workmanlike manner).

58. See *Drury*, 933 S.W.2d at 677.

provide services in a good and workmanlike manner.⁵⁹ The only evidence on this issue was submitted by the hospital and showed that it had acted in a manner consistent with good medical practice. Summary judgment in favor of the defendant was affirmed.⁶⁰

Although *Palm Harbor Homes, Inc. v. McCoy*⁶¹ did not involve substantive issues of breach of warranty, negligence, or DTPA liability, it did concern an important determination regarding the forum in which such claims must be heard. In *Palm Harbor* the purchasers of a mobile home sued the dealer and manufacturer for alleged defects in the goods. Because the contract contained a clause requiring all claims or controversies relating to the mobile home to be submitted to arbitration, the defendants moved to compel arbitration. After denial of this motion by the trial court, the defendants sought a writ of mandamus directing the trial judge to order arbitration. The court of appeals held that the transaction was one "involving commerce" under the terms of the Federal Arbitration Act.⁶² The court further held that, since the transaction fell within the terms of that act, the Texas requirement that a consumer's attorney sign an agreement providing for arbitration in transactions involving less than fifty thousand dollars was preempted.⁶³ The court rejected an argument that the purchasers were fraudulently induced to enter into the contract because the seller did not disclose the effect of the arbitration clause.⁶⁴ The trial court was instructed to issue an order compelling arbitration.⁶⁵

C. NOTICE OF BREACH

Pursuit of a breach of warranty claim under the Code requires that an aggrieved buyer give notice of the breach within a reasonable time after the breach has or should have been discovered.⁶⁶ There is no special formality required for the notice; it "need merely be sufficient to let the seller know that the transaction is still troublesome and must be watched."⁶⁷ In *Lochinvar Corp. v. Meyers*,⁶⁸ the court held that notice of breach given to a distributor approximately one year after installation of a furnace boiler constituted some evidence of timely notice and could not be ruled untimely as a matter of law, particularly when the installer had

59. *See id.*

60. *See id.*

61. 944 S.W.2d 716 (Tex. App.—Fort Worth 1997, no writ).

62. *Id.* at 721. The relevant portion of the Federal Arbitration Act appears at 9 U.S.C. §§ 1-2 (1994).

63. *See Palm Harbor Homes*, 944 S.W.2d at 721. At the time of this decision, the requirement that a consumer's attorney sign a contract containing an arbitration clause appeared in TEX. CIV. PRAC. & REM. CODE ANN. § 171.001(b) (Vernon 1997). As revised during the 1997 legislative session, the relevant provision now appears as TEX. CIV. PRAC. & REM. CODE ANN. § 171.002(b) (Vernon Supp. 1998). *See* Act of April 17, 1997, 75th Leg., R.S., ch. 165, § 5.01, 1997 Tex. Gen. Laws 329.

64. *See Palm Harbor Homes*, 944 S.W.2d at 722-23.

65. *See id.*

66. *See* TEX. BUS. & COM. CODE ANN. § 2.607(c)(1) (Tex. UCC) (Vernon 1994).

67. *Id.* § 2.607 cmt. 4.

68. 930 S.W.2d 182 (Tex. App.—Dallas 1996, no writ).

been informed of the problems six months earlier and the installer had contacted the distributor at that time.⁶⁹

D. REJECTION OF GOODS

Under the Code, the failure of a buyer to reject goods within a reasonable time after they are tendered constitutes acceptance.⁷⁰ Once accepted, the buyer must pay for the goods at the contract rate, subject to any damages for breach of warranty or the like that the buyer may have suffered.⁷¹ In *Glenn Thurman, Inc. v. Moore Construction, Inc.*,⁷² the court recognized that these provisions of the Code displace the common law of contracts which may excuse the performance of an aggrieved party if the other party has failed to perform its own obligations under the contract.⁷³ The court held that, under the Code, the doctrine of excused performance does not apply and that the burden of pleading and proving rejection of goods is on the buyer. Because the trial court had erroneously submitted a jury question on excused performance and the buyer had neither pled nor proven rejection of the goods, judgment in favor of the buyer was reversed and the case was remanded for a new trial.⁷⁴

E. ALPHABET CONTRACTS

In addition to its legal significance, Chapter 2 of the Code can be a useful source for crossword puzzle terms. For example, "Term used for delivery of goods at a named place of shipment or destination,"⁷⁵ or, "Term used to indicate that the price of goods includes cost of shipment to a named destination, are provided in the chapter."⁷⁶ This latter term was applied by the court in the in rem action, *The Cargo Vessel Nazli Poyraz*,⁷⁷ to determine that the title to goods shipped under a cost and freight (C&F) term in a letter of credit passed to the buyer when the goods were loaded on board the vessel. Because title passed at that time, the buyer was a real party in interest who could maintain an action against the vessel to recover for expenses incurred by the buyer to clean fuel oil stains from the goods that were caused by leakage in the vessel during shipment. The court noted that, under the Code, a C&F term creates a shipment contract under which the risk of loss passes to the buyer if the seller has fulfilled its responsibilities to put the goods into the hands of a carrier under an appropriate contract.⁷⁸

69. See *id.* at 190.

70. See TEX. BUS. & COM. CODE ANN. § 2.606 (Tex. UCC) (Vernon 1994).

71. See *id.* § 2.607(a) & (b).

72. 942 S.W.2d 768 (Tex. App.—Tyler 1997, no writ).

73. See *id.* at 772.

74. See *id.* at 773.

75. Answer: F.O.B. See TEX. BUS. & COM. CODE ANN. § 2.319 (Tex. UCC) (Vernon 1994).

76. Answer: C. & F. See TEX. BUS. & COM. CODE ANN. § 2.320 (Tex. UCC) (Vernon 1994).

77. 945 F.Supp. 140 (S.D. Tex. 1996).

78. See *Nazli Poyraz*, 945 F.Supp. at 143.

F. STATUTE OF LIMITATIONS

Section 2.725 of the Code provides a four year limitations period for breach of warranty actions unless the warranty explicitly extends to future performance.⁷⁹ Chapter 2 of the Code, however, only applies to contracts for the sale of goods.⁸⁰ In *Harrison County Finance Corp. v. KPMG Peat Marwick, L.L.P.*⁸¹ the court reached the inexplicable conclusion that this section applied to an express warranty that accounting services would be performed at "the highest level of professional performance"⁸² and that the limitations period had run on the warranty claim. There was no indication that any sale of goods was involved in the transaction. On associated negligence and DTPA claims, the court held that the two year limitations period for negligence and DTPA actions did not begin to run until the plaintiff knew or should have known of the negligent act and the resulting injury.⁸³ Because the defendant did not show when the plaintiff knew or should have known of the negligent act or the DTPA misrepresentations, summary judgment in favor of the defendant was reversed and the case remanded for trial on the negligence and DTPA claims.⁸⁴

III. LEASES OF GOODS

LaBella v. Charlie Thomas, Inc.,⁸⁵ could be regarded either as a classic example of the legal reasoning process or as an objectionable example of judicial activism, depending on one's point of view. In *LaBella*, the lessee of an automobile had problems with it some eighteen months after the beginning of the lease term. He took the car back to the lessor's place of business where mechanics disassembled the engine to determine if the repairs were covered by the limited warranty contained in the lease. After disassembly, the lessor denied coverage under the warranty, but the lessee refused to pay some \$500 in cash for the "tear down" work. At this point the lessor put the parts in the trunk, threw the lessee's credit card at him and pushed him out the door. The lessee eventually paid cash to regain possession of the car and had it repaired elsewhere. The lessee then filed suit for breach of warranty, negligence, DTPA violations, and assault.

As the beginning point for its analysis, the court noted that, while Texas courts have consistently refused to apply the warranty provisions of Chapter 2 on Sales to lease transactions, Chapter 2A now covers Leases of personal property.⁸⁶ This case arose, however, before the effective date of Chapter 2A so the implied warranties in Chapter 2A were not

79. See TEX. BUS. & COM. CODE ANN. § 2.725(a), (b) (Tex. UCC) (Vernon 1994).

80. See *id.* § 2.102.

81. 948 S.W.2d 941 (Tex. App.—Texarkana 1997, pet granted).

82. *Id.* at 947.

83. See *id.* at 946.

84. See *id.* at 948.

85. 942 S.W.2d 127 (Tex. App.—Amarillo 1997, writ denied).

86. See *id.* at 131.

applicable. Instead of simply disposing of the case on the ground that neither Chapter 2 nor Chapter 2A applied, the court took a different tack and ruled that the transaction "would be governed by common law warranties of merchantability."⁸⁷ With this bit of judicial sleight of hand, the court steered a course that remained within existing precedent but still provided a basis for the implication of warranties in an egregious fact situation. Having determined that a common law implied warranty of merchantability existed, the court went on to hold that an attempted disclaimer by the lessor and the manufacturer that might have been conspicuous and effective as a matter of law in sales cases under Chapter 2, should be treated as a question of fact in this case because it involved a lease and the terms of the disclaimer made reference to a sale.⁸⁸ The case was remanded for trial on the warranty claim and on the claims for DTPA violations, negligence, and assault.⁸⁹

IV. NEGOTIABLE INSTRUMENTS AND BANK DEPOSITS AND COLLECTIONS

A. IMPACT OF REVISED CHAPTERS 3 AND 4

The comprehensive revisions of Chapters 3 and 4 of the Code during the 1995 legislative session that became effective on January 1, 1996, have placed the Texas courts in a transitional phase on the subjects of negotiable instruments and bank deposits and collections.⁹⁰ The effect of this transition can be seen in three cases reported during the Survey period.

In *Texas Stadium Corp. v. Savings of America*,⁹¹ the court addressed the question of whether warranties made upon the presentment of a check run not only to the payor bank, but also to the drawer of the check.⁹² The court observed that, under the prior version of the Code, there was a split of authority among the states on this issue, but there was no Texas authority on point.⁹³ Given this dearth of authority, the court looked to the revised Chapter 3 as an aid to interpretation and noted that the revision specifically rejects the idea that warranties on presentment

87. *Id.*

88. As stated by the court, the question was "whether the disclaimers provided by appellees, which clearly refer to the sale of a vehicle, were sufficient to provide appellant, as lessee, with the required notice of the disclaimer of all implied warranties." *LaBella*, 942 S.W.2d at 134 (emphasis in original).

89. *Id.* at 138.

90. Chapter 3, formerly titled "Commercial Paper," was replaced by a new Chapter 3 entitled "Negotiable Instruments." See Act of May 28, 1995, 74th Leg., R.S., ch. 921, §§ 1-2, 1995 Tex. Gen. Laws 4582, 4626. Chapter 4 retained the title of "Bank Deposits and Collections" but was extensively revised by the same Act. See Act of May 28, 1995, 74th Leg., R.S., ch. 921, § 4, 1995 Tex. Gen. Laws 4226, 4642.

91. 933 S.W.2d 616 (Tex. App.—Dallas 1996, writ denied).

92. Presentment warranties arise under both Chapters 3 and 4 of the Code. These warranties are identical in substance and are separately stated only because of the different contexts in which they may arise. See TEX. BUS. & COM. CODE ANN. § 3.417 (Tex. UCC) (Vernon 1994 & Supp. 1998) and TEX. BUS. & COM. CODE ANN. § 4.208 (Tex. UCC) (Vernon 1994 & Supp. 1998).

93. See *Texas Stadium*, 933 S.W.2d at 621.

run to the drawer as well as to the payor bank.⁹⁴ Because the old Code was unclear on this issue, and because the revised Code specifically rejects the line of cases allowing a drawer to sue for breach of presentment warranties, the court held that it would adopt the same rule as that espoused in the revised Code and deny the drawer the right to sue for breach of presentment warranties.⁹⁵

In *Miller-Rogaska, Inc. v. Bank One, Texas*,⁹⁶ the named payee on a check who had never obtained possession of the instrument sued the depository bank and the payor bank for conversion of the instrument when it was paid over an unauthorized indorsement to someone other than the payee. The court held that a named payee who does not obtain either actual or constructive possession of a check cannot qualify as a holder of the check.⁹⁷ Under its reading of cases decided under the earlier version of the Code, the court ruled that only a holder could maintain an action for conversion of an instrument and that the payee's failure to qualify as a holder required summary judgment in favor of the banks.⁹⁸ As further support for its decision, the court noted that the revised Code now provides expressly that a conversion action may not be maintained by a payee who does not receive delivery of an instrument and that this amendment resolves any confusion about this issue that may have existed prior to the amendment.⁹⁹

In *Basse Truck Line, Inc. v. First State Bank*,¹⁰⁰ an employee began defrauding his employer by presenting a series of fraudulent premium invoices in the name of the employer's insurance carrier, "Texas Insurance Agency, Inc." He then indorsed the checks issued to pay these invoices in the name "Texas Insurance," which was similar to, but not identical with, the name of the payee appearing on the check, and deposited the checks in a bank account he had opened in the name "Texas Insurance." After the scheme was discovered, the employer, as drawer of the checks, sued the various banks that had handled the checks in the process of collection and payment. The employer argued that the "impostor rule" under the prior version of the Code required an indorsement identical to the name of the payee appearing on a check.¹⁰¹ Since the

94. *See id.*

95. *See id.* at 622.

96. 931 S.W.2d 655 (Tex. App.—Dallas 1996, no writ).

97. *See id.* at 660.

98. *See id.* at 661. In reaching this conclusion the court relied heavily on the case of *Rex Smith Propane, Inc. v. National Bank of Commerce*, 372 F. Supp. 499 (N.D. Tex. 1974). It should be noted that this is only a lower federal court decision interpreting Texas law in the absence of controlling Texas precedent. *Miller-Rogaska* was, therefore, only one step removed from the "no precedent" situation presented in *Texas Stadium* described in the text accompanying notes 92-96.

99. *See Miller-Rogaska*, 931 S.W.2d at 661-62.

100. 949 S.W.2d 17 (Tex. App.—San Antonio 1997, writ denied).

101. The impostor rule appeared in the former Chapter 3 as TEX. BUS. & COM. CODE ANN. § 3.405(a)(3) (Tex. UCC) (Vernon 1994). As revised, it now appears as TEX. BUS. & COM. CODE ANN. § 3.404(b), (c) (Tex. UCC) (Vernon Supp. 1998). *See* Act of May 28, 1995, 74th Leg., R.S., ch. 921, § 1, 1995 Tex. Gen. Laws 4597, 4616.

indorsements in question here did not exactly match the name of the payee on the checks, the employer contended the banks should be liable for wrongfully paying the amount of the checks to the faithless employee. The court disagreed, noting that the revised Code rejects the requirement of an exactly matching indorsement and disapproves earlier decisions to the contrary.¹⁰² In a frank recognition of the impact the revised Code has on this issue, the court declined to adopt a reading of the prior Code that "would be immediately obsolete, considering the legislature's action."¹⁰³ The court ruled that the substantial similarity of the indorsements was enough to put the loss resulting from the employee's fraud on the employer rather than on the banks.¹⁰⁴

B. LOST, DESTROYED, OR STOLEN INSTRUMENTS

In *Geiselman v. Cramer Financial Group, Inc.*,¹⁰⁵ the issue was whether the purported owner of two promissory notes was required to prove that it had possession of the notes prior to their loss or destruction. Relying on, and quoting from the opinion in *Western National Bank v. Rives*,¹⁰⁶ discussed in last year's Survey,¹⁰⁷ the court held that the old Code should be interpreted in a manner consistent with the requirement of the revised Code that an owner of a lost instrument must show prior possession of the instrument to recover on it after its loss or destruction.¹⁰⁸

C. DEPOSIT CONTRACTS AND CORPORATE RESOLUTIONS

The authority of an agent to sign instruments can arise either in situations involving the agent's authority to sign checks for the principal as the drawer or to indorse checks for the principal as the payee or other holder. In many cases a bank will require the principal, who is frequently a corporation, to provide a corporate resolution identifying the person or persons who are entitled to sign or indorse checks. While such a resolution is generally a good idea for a bank, it can occasionally backfire, as illustrated by *Humble National Bank v. DCV, Inc.*¹⁰⁹

102. See *Basse Truck*, 949 S.W.2d at 20.

103. *Id.*

104. See *id.* at 21. The court also rejected the employer's contention that the payor bank had violated the DTPA by shortening the time limits provided in TEX. BUS. & COM. CODE ANN. § 4.406 (Tex. UCC) (Vernon 1994 & Supp. 1998) in its depositor agreements. In the absence of Texas case law on the issue, the court found that other jurisdictions had approved such agreements and that it found the reasoning in these jurisdictions persuasive. See 949 S.W.2d at 22.

105. No. 14-96-00265-CV (Tex. App.—Houston [14th Dist.] Aug. 28, 1997, n.w.h.) (not designated for publication), 1997 WL 528630.

106. 927 S.W.2d 681 (Tex. App.—Amarillo 1996, writ denied).

107. See John Krahmer, *Commercial Transactions*, 50 SMU L. REV. 1038-39 (1997).

108. See *Western National*, 927 S.W.2d at 685. The old Code did not specify whether prior possession was required. See TEX. BUS. & COM. CODE ANN. § 3.804 (Tex. UCC) (Vernon 1994). The revised Code now specifically requires that the owner have been in possession of the instrument. See TEX. BUS. & COM. CODE ANN. § 3.309(a)(1) (Tex. UCC) (Vernon Supp. 1998); Act of May 28, 1995, 74th Leg., R.S., ch. 921, § 1, 1995 Tex. Gen. Laws 4594, 4625.

109. 933 S.W.2d 224 (Tex. App.—Houston [14th Dist.] 1996, writ denied).

In *Humble* the court addressed two principal issues. First, whether a bank breached an express warranty to its customer under the DTPA based on advertising that the bank had "A Tradition of Excellence" and a policy of "knowing its customers."¹¹⁰ Second, whether a corporate resolution protected a bank from liability for issuing cashiers' checks to a corporate representative when the terms of the resolution authorize a different person to "endorse and cash checks."¹¹¹

On the issue of breach of express warranty, the court carefully analyzed prior law under the DTPA on what constitutes an express warranty and concluded that the slogan "A Tradition of Excellence" and the advertisement of "knowing its customers" was mere opinion or puffing insufficient to create an express warranty.¹¹² On the issue of authority granted by the corporate resolution, the bank argued that the representative had apparent authority to obtain cashiers' checks, but the court held that a cashier's check is the functional equivalent of cash and, therefore, issuing cashiers' checks to someone other than the person specified in the resolution was tantamount to cashing the corporate checks. Because the bank, at its own request, had obtained the corporate resolution and had it in hand when the cashiers' checks were issued, it could not claim apparent authority of the agent as a means of avoiding liability to its corporate customer.¹¹³

D. LEGISLATIVE CHANGES

During the 1997 legislative session, Texas added a non-uniform provision to section 3.118 providing that the six-year limitations period for notes stated in section 3.118 does not apply to actions involving a real property lien covered by the four year limitations period in the Civil Practice and Remedies Code for the enforcement of real property liens.¹¹⁴ This amendment eliminates the uncertainty that existed previously in regard to the relationship between the limitations periods in section 3.118 and the Civil Practice and Remedies Code. This earlier uncertainty about the limitations periods is discussed in the State Bar Committee Comment to section 3.118 in the Business & Commerce Code.¹¹⁵

Another non-uniform amendment added during the 1997 legislative session was the addition of a new warranty to Chapters 3 and 4 of the Code to deal with situations in which a third-party draws a draft against a

110. *See id.* at 229.

111. *See id.* at 236.

112. *See id.* at 231.

113. *See id.* at 238.

114. *See* TEX. BUS. & COM. CODE ANN. § 3.118(h) (Tex. UCC) (Vernon Supp. 1998). The four year limitations period in the Civil Practice and Remedies Code are contained in TEX. CIV. PRAC. & REM. CODE ANN. §§ 16.035, 16.036 (Vernon 1986 & Supp. 1998).

115. *See* TEX. BUS. & COM. CODE ANN. § 3.118 cmt. (Tex. UCC) (Vernon Supp. 1998).

customer's account.¹¹⁶ Such third-party drafts may be used to make routine, recurring payments on obligations of the customer, such as the monthly payment of insurance premiums, or they may be used in single payment situations, such as payments for merchandise ordered by telephone or by computer. The new warranty provides that any person or collecting bank presenting a third-party draft for payment, or any prior transferor, warrants that the draft has been authorized by the customer. The purpose of this warranty is to protect subsequent holders and payors who take or pay such a draft when it has not been authorized by the customer by providing a right of recourse against the presenter or any prior parties. Because of the non-uniform nature of this amendment, a special conflict of laws rule was also added providing that the warranty will have limited effect if the law of the transferor's jurisdiction does not provide for a similar warranty.¹¹⁷ Provisions were also added to the definitions of negotiable instruments in section 3.104 to designate such third-party drafts as "demand drafts."¹¹⁸

V. FUNDS TRANSFERS

A. NAME AND NUMBER INCONSISTENCIES (BENEFICIARY)

In *G4 Trading, Inc. v. NationsBank of Texas*,¹¹⁹ the court held that a typed set of instructions containing an incorrect account number given to a bank employee by the president of the originating company was sufficient to show that permission was given to the bank to act on those instructions and was also sufficient to support jury findings against the originator.¹²⁰ The court concluded that the written instructions provided by the president on behalf of the company constituted written authorization and manifested the company's intention to have the bank act upon the instructions.¹²¹ Testimony showed that the president knew of the bank's policy that they would make the transfer if written authorization was given and that he did leave the instructions with the bank.¹²² Testimony also showed that it was common for customers to bring in their written instructions and for the bank to follow such instructions in executing a wire transfer.¹²³

116. The new warranty provisions appear in TEX. BUS. & COM. CODE ANN. §§ 3.416(a)(6), 3.417(a)(4), 4.207(a)(6), 4.208(a)(4) (Tex. UCC) (Vernon Supp. 1998). Although appearing in several different subsections, the substance of the warranty is the same.

117. See TEX. BUS. & COM. CODE ANN. §§ 3.416(e), 3.417(g), 4.207(e), 4.208(g) (Tex. UCC) (Vernon Supp. 1998).

118. See TEX. BUS. & COM. CODE ANN. § 3.104(k) (Tex. UCC) (Vernon Supp. 1998).

119. 937 S.W.2d 137 (Tex. App.—Houston [1st Dist.] 1996, no writ).

120. See *id.* at 141.

121. See *id.*

122. See *id.* at 140.

123. See *id.*

VI. BILLS OF LADING AND WAREHOUSE RECEIPTS

A. LIABILITY FOR MISDELIVERY

In *Soto v. Sea-Road International, Inc.*,¹²⁴ a transportation company, acting on the seller's instructions, delivered goods to the buyer's customs agent under a delivery order that required the customs agent to check with the transportation company before any of the goods were released. The customs agent subsequently released the goods to a third party without first contacting the transportation company and the goods disappeared without any payment having been made to either the seller or to the transportation company.

In an action for conversion by the transportation company against the customs agent, the agent argued that he was not a bailee of the goods because a delivery order reserves no security interest in the goods under section 2.505 of the Code.¹²⁵ While the court agreed that this was a correct reading of that section, it also pointed out that, under section 7.102, once a delivery order has been accepted by the bailee, it is equivalent to a document of title.¹²⁶ Since the customs agent had accepted the delivery order, he became a warehouseman with respect to the goods and was bound to follow the instructions contained in the delivery order. Under these circumstances, the customs agent was liable in conversion for the value of the goods that had been improperly released.¹²⁷

VII. SECURED TRANSACTIONS

A. CREATION OF SECURITY INTEREST

Under section 9.203 of the Code, a secured party must give value to create an effective security interest. In *In re IPS Systems, Inc.*,¹²⁸ the court held that a law firm had given value sufficient to create a security interest in the retainer paid to the firm by a debtor whom the firm agreed to represent prior to the filing of the debtor's bankruptcy. The court held that, while the security interest and payments from the retainer were subject to later review by the bankruptcy court, it met the requirements of section 9.203 for the creation of a valid prepetition security interest.¹²⁹

If a seller or lender advances funds to a debtor to permit the debtor to acquire property to be used as collateral for the advance, a security interest in that collateral is termed a "purchase money security interest" and carries with it some special advantages under various provisions of Chapter 9. Even though a security interest may start out as a purchase money security interest, it may not remain a purchase money security interest if

124. 942 S.W.2d 67 (Tex. App.—Corpus Christi 1997, writ denied).

125. See *id.* at 73 (citing TEX. BUS. & COM. CODE ANN. § 2.505(a)(2) (Tex. UCC) (Vernon 1994)).

126. See *id.* at 74 (citing TEX. BUS. & COM. CODE ANN. § 7.102 cmt. 3 (Tex. UCC) (Vernon 1991)).

127. See *id.*

128. 205 B.R. 88 (Bankr. S.D. Tex. 1997).

129. See *id.* at 89.

the debtor refinances the obligation. Under the "transformation rule," the refinancing of an obligation causes a purchase money security interest to lose its special character and it becomes an ordinary security interest. Outside bankruptcy, there is a split of authority on whether the transformation rule applies to a purchase money security interest.¹³⁰ In bankruptcy, however, the transformation rule is routinely applied as the secured party learned to its dismay in *In re Gonzales*,¹³¹ where the debtor signed a new note and security agreement to refinance an existing debt incurred for the purchase of furniture and to borrow additional funds from the creditor. The prior documents were marked "paid" when the debt was refinanced. Noting that the Fifth Circuit has adopted the "transformation rule," the court held that the security interest lost its purchase money status and could be avoided under section 522 of the Bankruptcy Code as a nonpossessory nonpurchase money lien.¹³²

In *In re White*¹³³ the secured party argued that, because it had repossessed the collateral prior to the debtor's bankruptcy, it had acquired a possessory security interest that could not be avoided by the debtor. Although the court recognized that there is a split of authority on this issue, it believed the better reasoned view was to determine if the parties intended the security interest to be a possessory interest.¹³⁴ Applying this test, the court held that, since the bank had acquired possession of the collateral by foreclosure instead of by the debtor's consent, the security interest was still a nonpossessory lien as contemplated by the policy of the Bankruptcy Code.¹³⁵

B. PERFECTION AND CONTINUATION OF SECURITY INTERESTS

Besides creating an effective security interest, a secured party must be sure the interest is properly perfected. In *In re Gulf Forge Co.*,¹³⁶ a financing statement describing collateral as "goods, including without limitation, inventory and furniture" was held to be sufficient to put a competing creditor on notice of a bank's security interest in the debtor's equipment.¹³⁷ In reaching this conclusion, the court noted that more specificity is required in a security agreement than in a financing state-

130. See *Borg-Warner Acceptance Corp. v. Tascosa Nat'l Bank*, 784 S.W.2d 129 (Tex. App.—Amarillo 1990, writ denied) (discussing the "transformation rule" and the competing "dual status rule").

131. 206 B.R. 133 (Bankr. N.D. Tex. 1997).

132. See *id.* at 136.

133. 203 B.R. 613 (Bankr. N.D. Tex. 1996). The Fifth Circuit adopted the transformation rule in *Roberts Furniture Co. v. Pierce*, 507 F.2d 990 (5th Cir. 1975). Section 522 of the Bankruptcy Code permits debtors to avoid certain nonpossessory nonpurchase money liens on collateral if they impair an exemption to which the debtor would otherwise be entitled. See 11 U.S.C. § 522(f) (1998).

134. See 203 B.R. at 616.

135. See *id.* In this regard the court noted, "To hold otherwise would subvert Congress' expressed intent that the debtors be entitled to their exemptions, even though the creditor should beat them in the race to the courthouse." *Id.* at 617.

136. 202 B.R. 238 (Bankr. S.D. Tex. 1996).

137. *Id.* at 241.

ment and that the language describing a security interest in "goods" in the financing statement was enough to put a searcher on inquiry notice as to what goods were covered.¹³⁸

Even if a security interest is properly perfected, a secured party must take steps to continue that perfection if a financing statement is nearing the end of its statutory five year life.¹³⁹ Under Chapter 9 a continuation statement may be filed to renew the filing for an additional five years.¹⁴⁰ Under a non-uniform Texas amendment to section 9.401, a continuation statement filed to continue perfection in farm equipment that was originally perfected before September 1, 1985 "must contain the information contained in the original financing statement."¹⁴¹ In *In re McCloy*,¹⁴² the failure of the secured party to include any description of the collateral in a continuation statement rendered the security interest unperfected. The court noted that, although the formal requisites for continuation statements are minimal, both Texas and Fifth Circuit authority requires that they be followed.¹⁴³

Even if a security interest is properly created and perfected, it may simply evaporate if the collateral vanishes. This happened to a bank in *In re Pitcock*,¹⁴⁴ where a security interest in crops was literally "eaten up" when the debtor rented out the land where the crops were growing as pasture land in exchange for pasture rents. By the time bankruptcy was filed, the cattle had eaten the crops and the debtor had spent the rental income on living expenses. Since there was no longer any collateral to secure the bank's claim, the court ruled that the bank had become a mere unsecured creditor.¹⁴⁵

The advantage gained by a secured party who properly creates, perfects, and continues a security interest in collateral is nicely illustrated by the decision in *Conoco, Inc. v. Amarillo National Bank*,¹⁴⁶ where a bank held a perfected security interest in the inventory and accounts receivable of a petroleum distributor. The distributor entered into a jobber's contract with Conoco to sell gasoline through the distributor's retail outlets. The contract allowed Conoco to setoff amounts owed to Conoco by the distributor against the credit card sales generated through the retail outlets. If sales were not sufficient to cover the amounts owed, Conoco would draft the distributor's account at the bank for the difference. The debtor eventually defaulted on its bank loans and the bank refused to pay

138. See *id.* at 243.

139. See TEX. BUS. & COM. CODE ANN. § 9.403(f) (Tex. UCC) (Vernon 1991) (providing that a financing statement is effective for a period of five years from the date of filing).

140. See TEX. BUS. & COM. CODE ANN. § 9.403(c) (Tex. UCC) (Vernon 1991).

141. TEX. BUS. & COM. CODE ANN. § 9.401(f) (Vernon 1991).

142. 206 B.R. 428 (Bankr. N.D. Tex. 1997).

143. See *id.* at 434.

144. 208 B.R. 862 (Bankr. N.D. Tex. 1997).

145. See *id.* at 866. Because there was no longer any collateral to secure the bank's claim, the court found it unnecessary to address the question of whether the description of collateral in the bank's security agreement was sufficiently broad to include pasture rents.

146. 950 S.W.2d 790 (Tex. App.—Amarillo 1997, pet. filed).

several drafts drawn by Conoco against the distributor's account. Conoco then began requiring the distributor to pay cash for its gasoline purchases, but continued to setoff against the credit card sales. The bank sued Conoco for conversion of its collateral alleging that it had a valid and perfected security interest in the distributor's accounts receivable.¹⁴⁷ The court held that the bank's security interest was superior to Conoco's unsecured right of setoff.¹⁴⁸ The court further held that the two year limitations period applicable to actions for conversion did not bar the bank's claim because the action was brought within two years after the bank discovered that the conversion had occurred.¹⁴⁹ Although the bank prevailed on these issues, the court ruled that the bank had failed to show, as a matter of law, that it had neither consented to the setoffs nor waived its claim to the collateral by permitting the distributor to continue in business following default.¹⁵⁰ The case was remanded for trial on the issues of consent and waiver.¹⁵¹

C. DISPOSITION OF COLLATERAL AFTER DEFAULT

In *Friedman v. Atlantic Funding Corp.*,¹⁵² the court overturned a summary judgment entered in favor of a secured creditor because the creditor failed to plead or prove that it had met the pleading and proof requirements established by *Greathouse v. Charter National Bank—Southwest*¹⁵³ for the recovery of a deficiency judgment following the repossession and disposition of collateral.

Although not directly involving the risk of improper disposition of collateral under Chapter 9, *Ellis County State Bank v. Kever*,¹⁵⁴ illustrates how attempts to collect a secured debt can get out of hand. In *Kever*, the secured party was unable to collect on a \$6,000 debt secured by office equipment and furniture. Frustrated by this turn of events, the creditor took the case to the district attorney and a grand jury indicted the debtor for hindering a secured creditor. The criminal district court eventually quashed the indictment and the district attorney declined to seek reindictment. The debtor then sued the secured party along with some other

147. See *id.* at 793.

148. See *id.* at 796.

149. See *id.* at 798. On this point the opinion contains a good discussion of the application of the discovery rule to conversion actions and the duty of the aggrieved party to use due diligence to discover that a conversion has taken place. See *id.* at 797-99.

150. See 950 S.W.2d at 795.

151. See *id.* at 800.

152. 936 S.W.2d 38 (Tex. App.—San Antonio 1996, no writ).

153. 851 S.W.2d 173 (Tex. 1992). The requirements established by *Greathouse* can be summarized as follows: (1) the creditor in a deficiency suit has the burden of initially pleading that a disposition of collateral was commercially reasonable; (2) this pleading may be made either specifically or generally; (3) if the allegations are specific, the creditor automatically assumes the burden of proving the allegations; and (4) if the pleading is general, the creditor is required to prove the disposition was commercially reasonable only if the debtor specifically denies such disposition in the answer.

154. 936 S.W.2d 683 (Tex. App.—Dallas 1996, no writ).

defendants for malicious prosecution and recovered a judgment that included a \$1,000,000 punitive damage award against the secured party.

In what appears to be the last in a series of appeals and remands,¹⁵⁵ the court of appeals ruled that the debtor had proven all of the elements required for a malicious prosecution claim and, under the standards required by *Transportation Insurance Co. v. Moriel*,¹⁵⁶ the punitive damage award was not excessive. Judgment against the secured party was affirmed.¹⁵⁷

D. AMENDMENTS TO CHAPTER 9

Two non-uniform amendments were added to Chapter 9 during the 1997 legislative session. Perhaps the most important of these was the addition of a means by which a security interest can be taken and perfected in a nonnegotiable certificate of deposit (sometimes called a "book-entry CD"). Under this amendment, the definition of "instrument" in section 9.105 of the Code was expanded to include nonnegotiable certificates of deposit evidenced by a written document stating that the document is a certificate of deposit or a receipt for a book entry acknowledging that a sum of money was received by the issuer and that the money will be repaid by the issuer.¹⁵⁸ Conforming changes were also made to include such documents within the definition of "instrument" instead of within the definition of "deposit account."¹⁵⁹ These definitional changes were intended to distinguish nonnegotiable certificates of deposit from ordinary deposit accounts normally excluded from Chapter 9 by section 9.104.¹⁶⁰

The substantive portion of this amendment appears in section 9.304 which was revised to permit the issuer of a nonnegotiable certificate of deposit to obtain a possessory security interest in the certificate by placing a restriction on withdrawals from the account.¹⁶¹ By redefining "instrument" to include a book entry receipt showing issuance of a certificate of deposit, a secured party who is not the issuer can take a security interest in the deposit by taking possession of the document or receipt showing establishment of the certificate of deposit account. To gain priority, however, the secured party must give notice of the security

155. The case has had a lengthy appellate history. See *Ellis County State Bank v. Keever*, 870 S.W.2d 63 (Tex. App.—Dallas 1992), *aff'd in part, rev'd in part*, 888 S.W.2d 790 (Tex. 1994); 913 S.W.2d 605 (Tex. App.—Dallas 1995), *rev'd on other grounds*, 915 S.W.2d 478 (Tex. 1995).

156. 879 S.W.2d 10 (Tex. 1994).

157. See 936 S.W.2d at 690.

158. See TEX. BUS. & COM. CODE ANN. § 9.105(a)(14) (Tex. UCC) (Vernon Supp. 1998).

159. See TEX. BUS. & COM. CODE ANN. §§ 9.105(a)(5) & (a)(9) (Tex. UCC) (Vernon Supp. 1998).

160. See TEX. BUS. & COM. CODE ANN. § 9.104(12) (Tex. UCC) (Vernon 1994) (providing that Chapter 9 does not apply to the transfer of an interest in a deposit account except with respect to proceeds and priorities in proceeds).

161. See TEX. BUS. & COM. CODE ANN. § 9.304(a) (Tex. UCC) (Vernon Supp. 1998).

interest to the issuer before the issuer creates a security interest in the same account.

The second amendment to Chapter 9 was intended to protect purchasers of accounts and chattel paper to make it clear that the filing provisions of Chapter 9 may be used to document an outright sale that is not intended by the parties to be a secured transaction.¹⁶²

162. See TEX. BUS. & COM. CODE ANN. § 9.102(a)(2) (Tex. UCC) (Vernon Supp. 1998).